

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Date:

February 23, 2010

Legend

Taxpayer =

Fund =

State =

Type A Company =

Country =

Index =

a =

b =

c =

d =

e =

Dear :

This is in response to your letter dated August 9, 2009, requesting a ruling that (1) income and gain arising from the commodities-linked notes described below constitute qualifying income to Fund under section 851(b)(2) of the Internal Revenue Code of 1986, as amended (the "Code") and (2) income earned from Fund's investment in a wholly-owned subsidiary (Subsidiary) that is a controlled foreign corporation (CFC) under section 957(a) constitutes qualifying income to Fund under section 851(b)(2).

Facts

Fund intends to qualify as a regulated investment company (RIC) under section 851 of the Code. Taxpayer is a State statutory trust that is an open-end management investment company registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., as amended (the "1940 Act"). Taxpayer's investment currently consists of one investment portfolio, which is Fund.

Taxpayer represents that Fund intends to invest in commodities-linked notes having the terms and conditions of the following note (Note). The Note will be issued to Fund at a par value of \$a. Its payout formula will be determined with reference to the Index. The term of the Note will be one year. Fund, as the holder of the Note, will have the right to request prepayment of the Note at any time at the calculated redemption price based on the closing Index on the trading day on which the request is received or, in certain circumstances, the next following trading day. In addition, if, on any day, the if the Index falls b percent or more from the beginning value of the Index on the day when the Note was issued, then a mandatory repayment of the Note is triggered, and the Note will "knockout" and automatically redeem based on the closing Index value of the next trading day. The repayment obligation upon early redemption, knockout, or at maturity equals the face amount of the Note plus or minus the following adjustment. In calculating the adjustment, the face amount of the Note is multiplied by (1) a leverage factor of c percent and by (2) the percentage increase or decrease of the closing price of the Index on the day the Note was issued as compared to its value on the applicable payment calculation date. The total is then adjusted to account for a coupon amount calculated at the rate equal to one-month LIBOR minus a spread of d basis points times the face amount of the Note, for an annual fee amount of e percent of the notional value (leveraged face amount) of the Note, and for the reversal of an interest factor included in the Index.

Fund represents the following with respect to the Note:

- (1) The issuer of the Note will receive payment in full of the purchase price of the Note, substantially contemporaneously with the delivery of the Note;

- (2) Fund, while holding the Note, will not be required to make any payment to the issuer of the Note in addition to the purchase price paid for the Note, whether as a margin, settlement payment, or otherwise, during the life of the Note or at maturity;
- (3) The issuer of the Note is not subject by the terms of the instrument to mark-to-market margining requirements of the Commodities Exchange Act, 7 U.S.C. 2, as amended (the “CEA”); and
- (4) The Note is not marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to the CEA.

Fund intends to form a wholly-owned foreign subsidiary incorporated as a Type A Company under the laws of Country. Under the laws of Country, a Type A Company provides for limited liability for all holders of shares. A shareholder’s liability is limited to the amount, if any, unpaid with respect to the shares acquired by the shareholder. Subsidiary will file an election on Form 8832, Entity Classification Election, to be taxed as a corporation pursuant to section 301.7701-3 of the Procedure and Administration Regulations.

Fund represents that although Subsidiary will not be registered as an investment company under the 1940 Act, Subsidiary will comply with the requirements of section 18(f) of the 1940 Act, Investment Company Act Release No. 10666, and related Securities and Exchange Commission guidance pertaining to asset coverage with respect to transactions in commodity index swap agreements and other transactions in derivatives.

Fund will invest a portion of its assets in Subsidiary, subject to the asset diversification limitations set forth in section 851(b)(3) of the Code. Subsidiary is expected to invest in commodity futures, commodity and commodity index options, options on commodity futures, commodity and commodity index swap contracts and fixed income securities that serve as collateral for these contracts. Each of these contracts may be linked to the performance of one or multiple commodities (including a commodity index). Subsidiary may also invest in pooled investment vehicles, including those not registered under the 1940 Act, and Subsidiary may also engage in short sales.

Subsidiary will be wholly owned by Fund, and, as such, Fund represents that Subsidiary will qualify as a CFC. Fund expects that most or all of Subsidiary’s income will be “subpart F” income. Fund will include Subsidiary’s subpart F income for the taxable year in accordance with section 951 of the Code.

Law and Analysis

Section 851(b)(2) of the Code provides that a corporation shall not be considered a RIC for any taxable year unless it meets an income test. Under this test, at least 90 percent of its gross income must be derived from certain enumerated sources. Section 851(b)(2) defines qualifying income, in relevant part, as –

dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to [the RIC's] business of investing in such stock, securities, or currencies . . .

Section 2(a)(36) of the 1940 Act defines the term “security” as –

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

In addition, the flush language of section 851(b) of the Code provides that, for purposes of section 851(b)(2), there shall be treated as dividends amounts included in gross income under sections 951(a)(1)(A)(i) or 1293(a) for the taxable year to the extent that, under sections 959(a)(1) or 1293(c) (as the case may be), there is a distribution out of the earnings and profits of the taxable year which are attributable to the amounts so included.

Section 2(f)(1) of the CEA provides that the CEA is not applicable to a hybrid instrument that is predominantly a security. Section 2(f)(2) of the CEA provides that a hybrid instrument shall be considered predominantly a security if:

- (A) the issuer of the hybrid instrument receives payment in full of the purchase price of the hybrid instrument, substantially contemporaneously with the delivery of the hybrid instrument;
- (B) the purchaser or holder of the hybrid instrument is not required to make any payment to the issuer in addition to the purchase price paid under subparagraph (A), whether as margin, settlement payment, or otherwise, during the life of the hybrid instrument or at maturity;
- (C) the issuer of the hybrid instrument is not subject by the terms of the instrument to mark-to-market margining requirements; and
- (D) the hybrid instrument is not marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to this chapter.

Section 2(f)(3) of the CEA provides, in part, that for purposes of section 2(f)(2)(C) of the CEA, mark-to-market margining requirements do not include the obligation of an issuer of a secured debt instrument to increase the amount of collateral held in pledge for the benefit of the purchaser of the secured debt instrument to secure the repayment obligations of the issuer under the secured debt instrument.

Section 957 of the Code defines a “controlled foreign corporation” as any foreign corporation in which more than 50 percent of (1) the total combined voting power of all classes of stock entitled to vote, or (2) the total value of the stock is owned by United States shareholders on any day during the corporation’s taxable year. A United States shareholder is defined in section 951(b) as a United States person who owns 10 percent or more of the total combined voting power of all classes of voting stock of a foreign corporation. Fund has represented that it will own 100 percent of the voting power of the stock of Subsidiary. Fund is a United States person. Therefore, Fund represents that Subsidiary will qualify as a CFC under these provisions.

Section 951(a)(1) provides that, if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder of this corporation and who owns stock in this corporation on the last day of the taxable year in which the corporation is a CFC shall include in gross income the sum of the shareholder’s pro rata share of the CFC’s subpart F income for the taxable year.

Section 952(a)(2) defines subpart F income to include foreign base company income determined under section 954. Under section 954(a)(1), foreign base company income includes foreign personal holding company income determined under section 954(c). Section 954(c)(1)(A) defines foreign personal holding company income to include dividends, interest, royalties, rents, and annuities. Section 954(c)(1)(C) also defines personal holding company income to include the excess of gains over losses

from transactions (including futures, forward, and similar transactions) in any commodities. Section 954(c)(1)(C) does not apply to gains and losses which (i) arise out of commodity hedging transactions (as defined in section 954(c)(5)(A)), (ii) are active business gains or losses from the sale of commodities, or (iii) are foreign currency gains or losses (as defined in section 988(b)) attributable to any section 988 transactions.

Subsidiary's income from its investments in commodities and commodity-linked instruments may generate subpart F income. Taxpayer therefore represents that it will include in income Subsidiary's subpart F income for the taxable year in accordance with section 951.

Conclusion

Based on the facts as represented, we rule that income and gain arising from the commodities-linked notes constitutes qualifying income to Fund under section 851(b)(2). We further rule that subpart F income of Subsidiary that is attributable to Fund is income derived with respect to Fund's business of investing in the stock of Subsidiary and thus constitutes qualifying income to Fund under section 851(b)(2).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed regarding whether Fund qualifies as a RIC under Subchapter M of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

David B. Silber
David B. Silber
Chief, Branch 2
Office of Associate Chief Counsel
(Financial Institutions & Products)